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Oct. 21, 1998 **LETTER 1263**

RUSSELL ADAGE: "In a primary bear market everybody ultimately loses, but the winner is the one who loses the least."

RUSSELL'S INSTINCT: No two bear markets are alike, and most vary considerably. My instinct about this bear market is that it is going to be long, convoluted, deceptive, costly and subject to more manipulation than any other bear market in history. My older subscribers may remember my prediction that when the chips are down (and because debt levels in the US are now huge), this nation will follow its time-honored scenario of "inflate or die." Believe me, we are already on the path of "inflate" (see chart of MZM in the last Letter).

Most of the smaller cap stocks have suffered severe losses but so far the big-cap stocks have declined only 20% on average. In my opinion, this bear market will not end until the big cap stocks have declined to the point where they represent great values. "Great values" implies bargain price/earning ratios and dividend yields in the vicinity of 6%. This could take a few years or more to materialize. In the meantime, be prepared for a long, perplexing bear market in which few will come out unscathed.

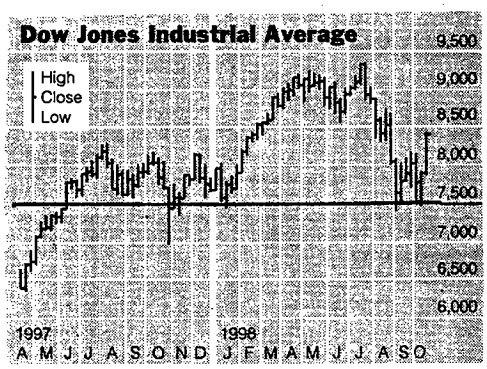
PRICE ACTION: The advance-decline ratio tracks the direction of the **majority** of stocks on the NYSE. In 37 years of monitoring the daily action of the A-D ratio, I've seen greater declines in the A-D than the one that began on April 3, but I can't remember a steeper, a more persistent or a more violent and costly one. In six months the stock market virtually collapsed with the average stock down around 45% from its 52-week high.

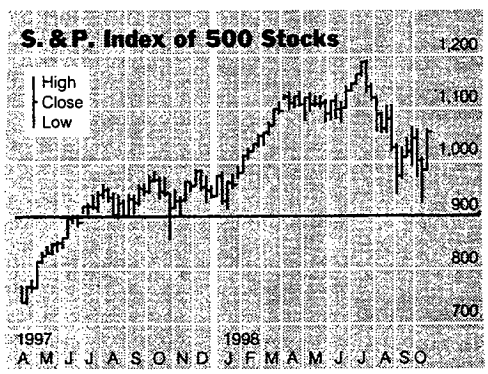
The bear market low for the Dow was set on **August 31 at 7539.07.** Since then the Dow has rallied, recovering one-third of its bear market losses, although the rest of the market has not fared nearly as well. For instance, since August 31 the following have broken below their extreme August lows: the NYSE Composite, the D-J Transports, the Nasdaq Composite, the Amex, the Value Line, the Russell Indices, and last but certainly not least, the advance-decline ratio for the NYSE and my own Primary Trend Index. Can the Dow and the S&P hold up against this parade of weaker indices? It may be until January before we get the answer. **The bear is in no hurry.**

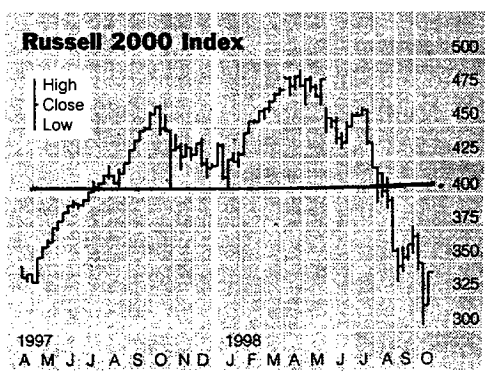
SUPPORT: The story of this bear market, so far, can be told very simply via the three little charts shown on this page. The first chart shows the Dow coming down from its July 17 peak of 9337.97, and it's clear that major Dow support comes in at roughly **7500.** The S&P 500 has declined from its July 17 peak of 1186.75, and you can see that support comes in at around **800.** How long it will take the bear to drive the averages below those support levels is anyone's guess, but my own guess is that those lows could hold until well into 1999. Oh yes, the third chart shows what's happened to the smaller cap stocks. The 400 level support on the Russell 2000 (an average of smaller cap stocks) was violated last August. In the meantime, brace yourself for a stream of nonsensical forecasts from leading analysts plus numerous confusing moves on the part of the major averages.

Oct. 9 DJIA 7899.52; PTI 5262; A-D Ratio +2.61
Oct. 16 DJIA 8416.76; PTI 5274; A-D Ratio +3.78
Dow Yield: 1.78%; Dow Price/Earnings: 21.8
Dow 144-day MA: 8390; Dow 34-day MA: 8032
Dow Times Book Value: 5.27; PTI 89-day MA: 5294
Percentage of Undervalued Blue-chips: 8%
Gold 34-day MA: 296

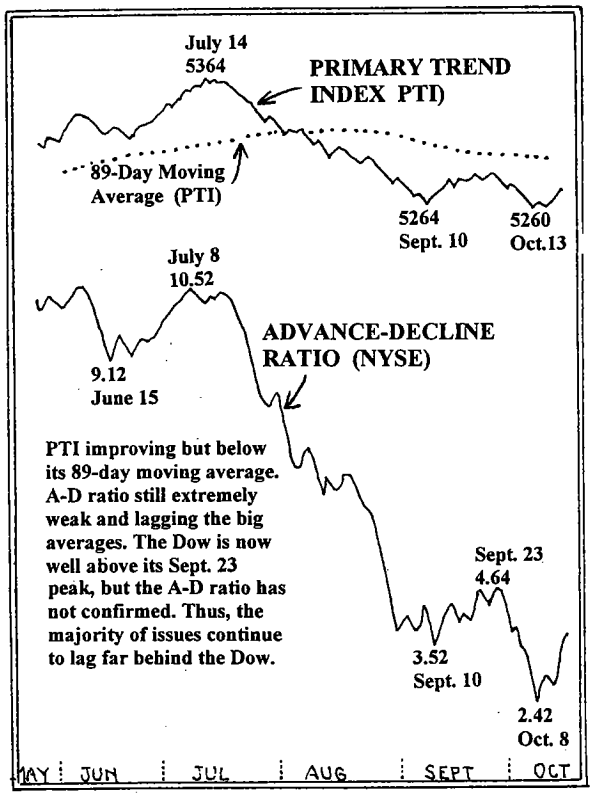
As this is written, it appears that investors believe that a pretty solid bottom was put in at the August 31 low. Furthermore, hopes have lifted based on Japan's move towards an S&L type bailout of leading Japanese banks. In the face of increasing optimism, the big cap stocks have led the market higher, and doubtless many neophyte investors are under the impression that the worst is over and that the bear is dead. Sadly, I must report that it won't be that easy. Ultimately, the bear will have his way. But it's going to take **time,** a lot of time. As I've said many times before, the Fed and the politicians are committed to fighting the bear tooth and nail. Their fighting will serve to **extend** the bear market far beyond what might ordinarily be expected.







CREDIT: What's this bear market all about? So far, it's been about a world-wide **credit crunch.** For that reason, anybody with any sense of what's happening has wanted to play it **safe.** That has meant out of junk bonds, out of emerging market bonds, out of most corporate bonds, out of mortgage-backed bonds, out of common stocks (except maybe high-grade utilities) -- and into government paper, meaning T-bills, T-notes and bonds. But problem -- the dollar has been in a free-fall. The D-mark, the Swissie, and now the Japanese yen have been surging against the dollar. Take a look at the Dollar Index (chart on page 2). For conservative US investors it's "get me out of everything -- and into government paper." For overseas investors,



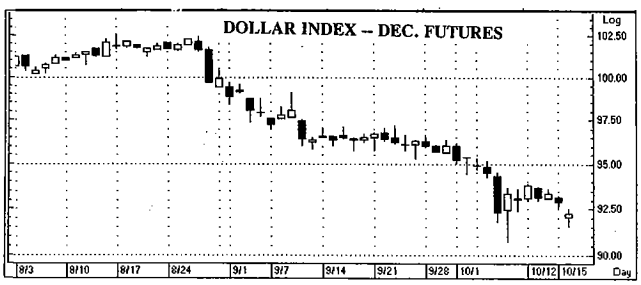
A Quick Turnaround

In Only 4 Months, Greenspan Changes Economic Tune

By RICHARD W. STEVENSON

WASHINGTON, Oct. 7 — Testifying before Congress in June, Alan Greenspan, the Federal Reserve chairman, is about to become the nation's longest peacetime expansion. But he fretted about the "somewhat scary psychology" afflicting financial markets and focused on the expectation that consumers would sharply cut back their spending because of the ... mand going forward to an unknown extent. We do not know how far it will go or how much it will affect consumer and business spending here at home."

Mr. Greenspan went on to say that this is "a time for monetary policy to be



it's "get me out of anything that's denominated in dollars -- and into European government paper."

Four months ago Fed Chairman Greenspan pronounced this US economy "the best he had ever seen." Oops, then two weeks ago Greenspan reversed himself, and, speaking before a group of economists in NYC, he stated that the economy had "weakened considerably," and that the Fed stood ready to reduce rates again. **Conclusion:** Greenspan missed the whole economic picture; he was just plain wrong (see clip on page 2).

In the meantime, the world's banks are beat-up, and credit is still drying up. The crunch is on. Nobody wants to extend credit because banks everywhere are already drowning in rotten loans -- and anything and everything is at risk. Interestingly, even in commercial real estate where there is an actual shortage here in the US, prices across the country are down 15% on average. A scarcity of property with prices down? How can that happen? Blame it on the panic for credit.

THE BIG PICTURE: It seems almost impossible to impress on the minds of investors that this is a primary bear market. Maybe it's been so long since the nation has experienced a true bear market that most investors don't understand what "bear market" means. A more likely suggestion is that most of today's investors weren't around during '73-'74 and therefore they have no idea of the havoc a bear market can wreak.

I was mulling over this whole situation the other day, and I realized that it's been 25 years, a quarter of a century, since the last true primary bear market. The typical mutual fund manager was wearing Brady Bunch pajamas during '73-'74. And I'm afraid these guys and gals don't have any conception of how tough a situation we may now be in for.

Obviously, no one can know how high a bull market will climb or how low a bear market will descend. But I recommend keeping one concept in mind when dealing with primary trends. The concept runs like this -- **bull and bear markets often go further than anyone thinks possible**. Certainly, the bear market that ended in 1974 did that. Certainly, the bull market of 1974-'98 did that. And I have to wonder whether the current bear market isn't going to do the same thing -- in time.

So the question arises, "How do we operate in a bear market?" Or to put it another way, "How does one survive in a bear market?" My answer: First, recognize that it IS a bear market. Second, treat the bear with respect, which means getting out of common stocks. Third, understand the critical importance of **patience.**

PATIENCE: This may sound trite, but probably the most difficult thing to do in either a bull or bear market is to exercise **patience.** In this world of instant information, perpetual talking heads, instant quotes, and fast-moving markets, it's very easy to lose sight of the big picture. And in the business of investing, the major consideration is always the **direction of the primary trend of the market.**

I've stated repeatedly that in a bull market values increase through time. Conversely, in a bear market values decrease through time. Furthermore, in a bull market all situations tend to work out favorably. Conversely, in a bear market, all situations tend to end unfavorably.

Back to patience. Patience has to do with the ability to sit through **time**, often boring time. A basic instinct among investors is always to "do something." But often, the correct posture is simply to sit with your basic positions and allow the primary trend (either bull or bear) to fully express itself.

Unfortunately, if you heed the advice of the TV commentators you will believe that the correct procedure is to react to the news of the day or even the news of the hour. "Are GM's earnings coming in above or below expectations?" "Is unemployment up or down for the month?" "Will McDonald's sell more hamburgers?" "When is Alan Greenspan scheduled to speak again?"

But this is not how real money is made, and this is not how costly losses are avoided. No, to really make money in a bull market you've got to be able to take a substantial position (at least substantial for you), and you've got to be able to **stay with that position** so that the full power of the primary bull trend can be allowed to work for you.

Consider if you had bought say any 10 Dow stocks in 1974 and held them through the whole bull market until 1998. Believe me, you would have done very well. You would have had 24 years of bull market action working for you.

Conversely, consider the advantage of selling out in the vicinity of the highs in a bull market. And then staying out until the bear market has hit its lows. Obviously, the advantage of avoiding a

major bear market is huge. But that takes the ability to act decisively. And it requires the patience to sit out a bear market.

By the way, that is exactly what I intend to do with my subscribers and with myself. I'm talking about having the fortitude to move out of the stock market and then having the patience to stay out until we receive enough information to indicate that the bear market is exhausted and that stocks are again a great buy.

S&P Indexes	% YIELD
500 Composite	1.65
Industrials	1.47
Transportation	1.34
Utilities	3.82
Financial	2.10
MidCap 400	1.52
SmallCap 600	1.07
SuperComposite 1500	1.53
Dow Jones Industrials	1.93

DIVIDENDS: Over the last few years (actually during most of the '90s) the cult of equities has taken hold; in the process, stock-buyers have largely ignored or even disparaged dividends. As a result, the yields on the various averages and in most stocks have dropped to never-seen-before lows. This is an anomaly which will be corrected in time.

In the last Letter I included a section on compounding. I termed compounding the "royal road to riches." Every seasoned, informed investor is well aware of the power of compounding. And every intelligent investor is well aware of what the "return on your investment" means. An attractive "return" is crucial in the compounding process. Give me a collection of high-quality, high-return securities and enough time -- and ultimately I'll own the world.

I was looking over S&P's weekly rundown of the main stock averages, and I show a few of their statistics here (page 3). What I'd like you to zero in on here are the **yields.** The only yield above 2% is in the Utility Average which provides a yield of 3.88%. As for the rest, the yields are ridiculously, dangerously low.

Yet yield is a very basic measurement of values. As I've said before, if you buy a stock which yields say 1.5%, you can't compound successfully at that low rate. All you can do is hope the stock goes up. If it doesn't, then you are simply tying up your money in a "non-performing" item. It's like putting money in a summer home that you don't rent and never use.

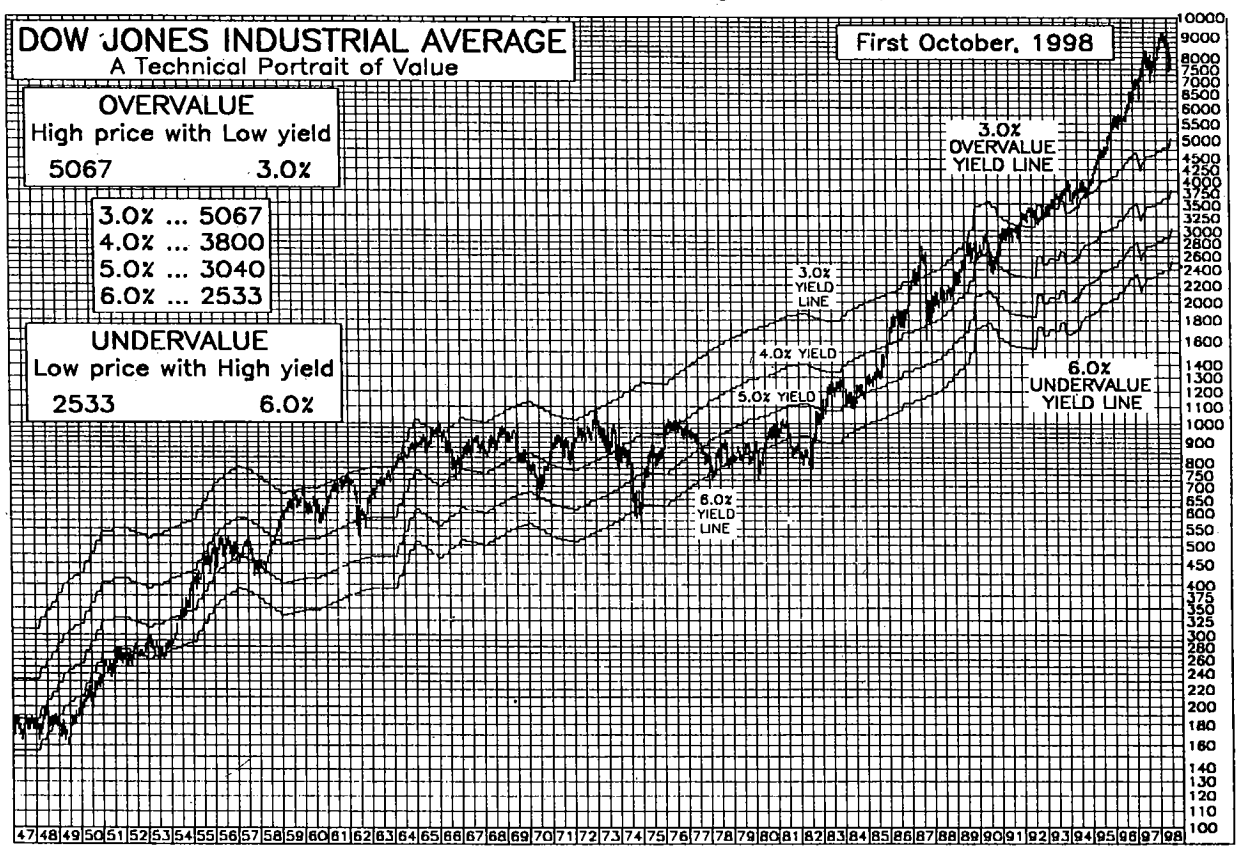
To further dramatize yield, I've included on page 3 a chart published by my good friends at *IQ Trends* (7440 Girard Ave., La Jolla, CA 92037). Here we see the Dow going back to the mid-1940s. The top channel line shows where the Dow would be at a 3% yield. Remember, this 3% has been, historically, the classic "danger level" for the Dow. At a yield of 3% or lower, the Dow (prior to the 1990s) was considered to be at a top.

The bottom channel line shows where the Dow would be at a yield of 6%. Many bear markets of the past have taken the Dow down to the 6% yield level, as you will note on the chart.

But here's an ironic and rather frightening consideration. This is a bear market, and over the longer-term the Dow is heading down. If the Dow was merely to drop to the 3% danger level, it would decline to 5057. Such a decline would mean that the Dow had declined 45.7% from its July 1998 high.

If the Dow was to decline to a level where it provided a 6% yield (and many bear market lows have seen the Dow at a yield of 6%), it would have to sink to 2533 (and lower if dividends were cut). A decline to 2533 would mean that the Dow had declined 72.8% from its July 1998 high. Such a decline would, if it materializes, represent the worst bear market since 1929-'32.

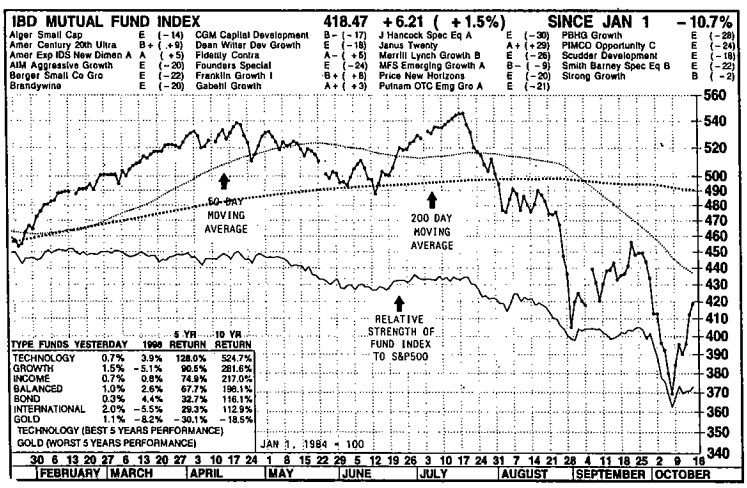
Could it happen? I remind subscribers of two items: (1) The market can do anything. (2) The greater and more speculative the bull market, the greater the odds that the following bear market will be severe, both in duration and extent. The 1974-'98 bull market was the greatest, the longest and the most speculative in stock market history. For this reason I, personally, do not expect a mild bear market (of course I could be wrong, as I often am).



Notes: (1) The latest Dow yield is 1.9%, still far below the classic 3% danger level. (2) Already, the average stock (all exchanges) is down around 44% from its 52-week high.

Bear Market?: The goofy "definition" of when it's a bear market continues in the press. The ultimate goofiness occurred on October 8 with the Dow dropped an intra-day 263 points but closed down 10. The *WSJ* announced that the Dow just missed being in a bear market, although if it had closed at the day's low (below 20%) it would have been in a bear market. **Russell Comment:** Believe it, this **is** a bear market, no matter what the *WSJ* decides and regardless of what day they decide it is or isn't or whether the Dow is down the "required 20%" or not.

MUTUAL FUNDS: If you still doubt that it's a bear market, study this chart of *Investor's Business Daily's* Mutual Fund Index. This is an composite of 23 leading equity growth funds. At the latest reading the Fund Index was down 21.2%. The funds at last week's low lost more than they did during the 1987 crash and its aftermath. Note the sliding relative strength line. Clearly, the funds have been unable to keep up with the S&P 500.


IBD MUTUAL FUND INDEX 418.47 +6.21 (+1.5%) SINCE JAN 1 -10.7%
50-DAY MOVING AVERAGE
200 DAY MOVING AVERAGE
RELATIVE STRENGTH OF FUND INDEX TO S&P500
TYPE FUNDS YESTERDAY 1998 5 YR RETURN 10 YR RETURN
TECHNOLOGY 0.7% 3.9% 128.0% 524.7%
GROWTH 1.5% -5.1% 90.5% 281.6%
INCOME 0.7% 0.8% 74.9% 217.0%
BALANCED 1.0% 2.6% 67.7% 196.1%
BOND 0.3% 4.4% 32.7% 116.1%
INTERNATIONAL 2.0% -5.5% 29.3% 112.9%
GOLD 1.1% -8.2% -30.1% -18.5%
TECHNOLOGY (BEST 5 YEARS PERFORMANCE)
GOLD (WORST 5 YEARS PERFORMANCE)
JAN 1, 1984 = 100
FEBRUARY MARCH APRIL MAY JUNE JULY AUGUST SEPTEMBER OCTOBER

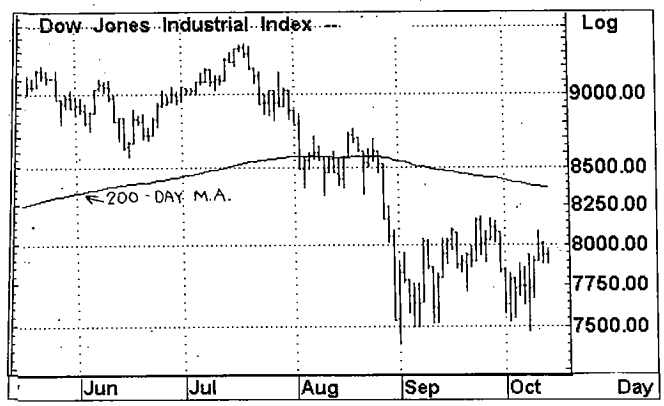
INVESTMENT POSITION: The bear remains in the box. The question is asked, "Russell, what would it take for you to turn bullish?" Well, if the Industrials and Transports turned around and advanced to new all-time highs I'd turn bullish. But honest, I don't think that's going to happen.

If we had a rally by both Averages, a decline, and then a new advance taking both Averages above the preceding peaks, I'd certainly have to say that the secondary direction of the market had turned bullish. The preceding peak for the Dow was 8154.41, while the preceding peak for the Transports was way up there at 2904.10.

Finally, if my PTI turns up, pushes above its 89-day moving average and continues to climb I'd have to be impressed. I wouldn't call it a new bull market, but I certainly wouldn't want to be short.

In the meantime, all my studies plus my instinct tell me that we're in the early stages of what promises to be an extended primary bear market. Old timers (and I guess I'm one) used to follow the Dow in relation to its 200-day moving average. In a bull market the Dow tended to stay above its 200-day MA, and in a bear market the opposite was true. At any rate, here's a chart of the Dow with its 200-day MA, and as you can see, the situation remains bearish. The 200-day MA comes in at about 8365 as this is written.

The great Russian writer, Dostoievsky wrote, "Be simple and rediscover the world." Let's paraphrase his wisdom and say, "Be simple and watch the Dow in relation to its moving average." The relationship is bearish.



ANNOUNCEMENT: I now offer CDs of Dow Theory Letters, ALL the Letters I've written since I started, which means December 26, 1958, right up to August 26, 1998. That's 40 years of Dow Theory Letters, over 1,250 Letters, the whole output on a single CD disc (sorry, PC only). What did Richard Russell say in late-1966, what did I say in December 1974, what did the market look like at the '68 highs, what about gold in 1970? History, musings, Russell's rantings, charts, stocks, gold, great calls, mistakes, goofs and gaffs, the works -- it's all here. Forty sweaty (my sweat) years of real-time Russell, yours for $400 per CD. Make checks out to Dow Theory Letters, PO Box 1759, La Jolla, CA 92038.

NOTES & QUOTES: Many technicians and fundamentalists place a good deal of credence in what they term the "presidential cycle." This four-year cycle indicates that in the third year of a president's term the markets have almost always done well. The "bullish portion" of the current presidential cycle should start around November 1 of this year. Also, a number of other cycles will be bottoming around November of this year. So it will be fascinating to see whether the various cycles work out, or whether the bear is powerful enough to thwart or at least mitigate the cycles. Older subscribers know the Russell opinion on cycles in general -- it's "where are they when you need them?"

* *

At a meeting of the World Bank and IMF in Washington two weeks ago, Clinton declared, "We must find ways to tame the cycles of boom and bust that shape today's economy." This boom, like every other boom, was built on a **gigantic expansion of credit.** And it is the bursting of the credit bubble that sets off the next bear market. If Clinton wants to tame the cycles, he will have to outlaw credit expansions and the human desire to make big bucks. It can't be done. The best thing that Clinton and the government can do is allow the free market to express itself without government interference. Bail-outs, the "too-big-to-fail" philosophy, the injection of more credit, all this will simply **extend** the bear market. In an op-ed article in the Oct. 13 *WSJ*, Nobel Prize winner Milton Friedman states, "The global economic crisis is the result of government intervening in the market, both internally and via loans, subsidies, or taxes, and externally via the IMF and other agencies. We do not need more powerful government agencies spending still more of the taxpayers' money, with limited or non-existent accountability . . . We need government, both within the nations and internationally, to get out of the way and let the market work."

* *

A subscriber asked me what I think should happen to Clinton. I told him, "During World War II, I was an Army Air Force cadet prior to becoming an officer. On our first day we were lined up and lectured by the camp's commanding officer. The CO told us, 'Gentlemen, listen carefully. Officers do not lie, and we will not tolerate lying. The men under your eventual command must believe in your absolute honesty. At times, their lives and your life will depend on their willingness to follow your orders. Men will not follow a liar. Therefore, gentlemen, if you are caught in a lie you will automatically be washed out of the Army Air Force Cadet Corp.'" **Russell Opinion:** Clinton is Commander-in-Chief of the armed forces. He has lied to the American people. I say, do to him what the armed forces would do to any lying officer. Wash him out. As head of the armed forces, he's not to be trusted. Get rid of him.

* *

Rumor: Clinton was sworn in to tell "The truth, the whole truth, and nothing but the truth." He answered, "I can't do that; you're talking about three different things."

* *

Abby Joseph Cohen, Wall Street's reigning guru has been the leading booster for this bull market. She is still bullish and is insisting that the S&P is 12% to 15% "undervalued." Cohen, however, is lowering her S&P earnings estimate to a 5% increase in '98 and 8% in '99. **Russell Comment:** It's a bear market. If you believe this, it's er, uh, rather difficult to project an increase in earnings next year. Evidently, Cohen doesn't believe we're in a bear market. What do I think? I think the US will be in recession next year, and that corporate earnings will be revised drastically to the downside.

* *

According to the October *Economist*, 56% of the American public believe Hillary will dump her husband once he is out of office. I tend to agree. Hillary, in case you haven't noticed, is going out and speaking in all directions -- on her own. And she is spending a lot less time with Bill. Hillary is also gaining in popularity, and she's feeling her power. So I have to wonder, is she positioning herself for political power in the Democratic party -- like maybe vice president in the next election?

* *

Did you see the special section of the *Wall Street Journal* (Oct. 5)? Thousands of mutual funds listed, pages and pages of mutual fund statistics. I shook my head. To me it looked like financial insanity. How can there possibly be thousands of smart, market-wise, managers of thousands of mutual funds? There are so damn many mutual funds that it's now harder to pick a good mutual fund than it is to pick a good stock. Furthermore, all these mutual funds must make profits for themselves, so these thousands of funds are all draining potential profits from the market. From January through July, 1997, the fund industry pumped out 647 new stock funds. This year during the same period 542 new funds were floated. Crazy, daffy, nutty. I don't think it's going to end well.

* *

The current melange and mish-mash of world currencies scares the regulators. Yet currencies are relentless in their cold-blooded appraisals of governments. Let a government be profligate, let a government act stupidly -- and its currency will go down the drain. Then the politicians scream that the FOREX traders have raped their country. Ridiculous. The free markets are saying that the country's policies are wrong, that nobody trusts their currency, and the results are to be expected -- a run on that nation's currency. A New World Economic Order? It won't work. Only free markets, tough and ruthless as they are, really work.

* *

Why are we so worried about Brazil? Answer: Because US banks have nearly $28 billion in loans at risk in Brazil (this is four times the amount the banks loaned to Russia). Furthermore, more than 2,000 US companies have investments in Brazil. This year Brazil has around $80 billion in debt coming due to foreign investors. Next year another $230 billion in outstanding debt will come due. Brazil doesn't have the money to pay off those huge debts. Brazil is importing more than it exports. And the Brazilian government is a big spender. Brazil is talking about pulling in its horns and spending less. But will Brazil's citizens accept austerity and probably a recession? Doubtful. The US and IMF solution: Assemble a $30 billion bailout package for Brazil. **Russell Comment**: Yeah, that should do it.

* *

American Heritage magazine picked the 40 richest Americans of all time. Candidates' assets were translated into current dollars. Surprise, of the 40 richest, only three are alive today. The three are Bill Gates, Warren Buffett and Gates' partner, Paul Allen. The absolute richest man was John D. Rockefeller with a fortune (translated into current dollars of $189 billion). Second was Andrew Carnegie with $100.5 billion. Third, Cornelius Vanderbilt with $95 billion. Fourth, John Jacob Astor with $78 billion. Fifth, ah, our own Bill Gates with $61 billion (less now with MSFT stock below 100). Interestingly, John D. Rockefeller's massive fortune was equal to about one sixty-fifth of the entire US GDP (but remember, there was no income tax at the time). Here's a surprise: Of the 100 richest Americans George Washington ranks #59 and Ben Franklin is #86.

* *

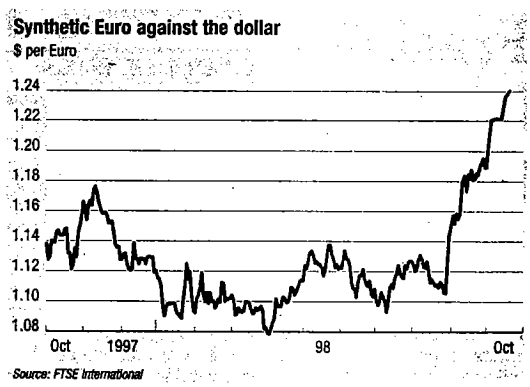
Referring to the compounding section in the last Letter, suppose you and I could compound our assets free of the income tax? We would almost surely be multi-millionaires. The income tax is the biggest wealth destroyer ever devised by the mind of man. And sadly, the income tax is the main support for BIG government with all its disgusting waste.

* *

The pre-recession problems are beginning to emerge. According to Challenger, Gray and Christmas, a Chicago outplacement firm, for the first eight months of 1998, layoffs are up 37% over last year and are at the highest levels since 1994. And job creation, the new jobs needed to offset layoffs, is at its lowest level in nearly three years.

* *

Following its August 26 peak, the dollar has literally crashed, first against the D-mark and Swissie and then against the yen. The collapsing dollar has set off a run out of US bonds, as overseas bond-buyers rush to cash in their profits. In the meantime, Europe's new single currency, the euro, has surged against the dollar as this chart shows.



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Words from America's #1 hypocrite: "Yes, the President should resign. He has lied to the American people, time and time again and betrayed their trust. He is no longer an effective leader. Since he has admitted guilt, there is no reason to put the American people through an impeachment. He will serve absolutely no purpose in finishing out his term. The only possible solution is for the President to save some dignity and resign." -- William Jefferson Clinton, 1974 on the then-President Nixon. (Thanks to my old friend, Ken Gammage of the *Richland Report*, here in La Jolla, for finding this gem.)

* *

Last week Ted Turner called for a worldwide policy of one child per family. Asked why he had five kids, Turner replied, "I was told at the time, 'If you want them and can afford them and you

can educate them, you should have them.' You can call me a hypocrite if you want to but I did not know at the time, I did not know." **Russell Comment:** I'm in the same fix. I have five kids (one is autistic), I supported them all the way, but I also believe the world population must be controlled. I didn't know, I didn't know. Now I have one dog, a standard poodle (female). But honest, she's fixed.

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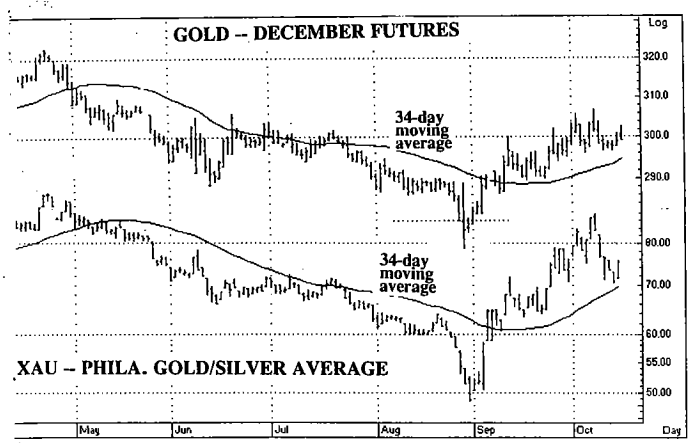
I've written many times about the three psychological stages of a bear market. In a recent book, John Schott, a psychoanalyst and pioneer in the study of investors' emotions, writes of bear markets: "The earliest stage is characterized by denial, increased anxiety and fear. The second stage is panic. People suddenly say, 'I've got to sell.' The third phase is despair, people stop buying stocks."

GOLD: All is not lost in the gold picture, although gold-philes may be a bit discouraged by the recent gold action. I continue to believe that we saw THE bottom for gold on August 28, on which day the December futures hit an extreme intra-day low of 273.80. Since then the December futures rallied to record an October 8 intra-day high of 306.90. Gold then backed off. But as this is written gold is holding above its 34-day moving average, which now stands at 295. And XAU, the widely-watched Phila. Gold/Silver Stock Average holds above its own MA, which stands at 72.

What lies in gold's future? For one thing, it's clear that the US and the world are trying to "bail themselves out" of this bear market by printing currency. As the mountains of paper currencies pile up, upward pressure increases on the gold price. Whether the world can actually print itself out of a bear market remains to be seen. Investors are increasingly concerned with risk -- risk in corporate profits, risk in leverage, risk in hedge funds and risk in the very value of the currencies themselves.

In the meantime, the US money supply continues to surge, and at the same time the dollar has turned weak. To this add a very negative US trade balance. This is probably the triple-combination that has moved gold higher.



LATE NOTES: It's obvious that the Fed is worried, and it's equally obvious that the Fed has decided not to wait. It's rare that the Fed makes a move on interest rates prior to a Fed open market meeting, but this time the Fed moved fast -- and this was rather cute, the cuts were made a day before option expiration. A hoard of traders and short sellers were caught by the unexpected cut in both the Fed funds and the discount rate, and the result was a great surge of 330 points in the Dow.

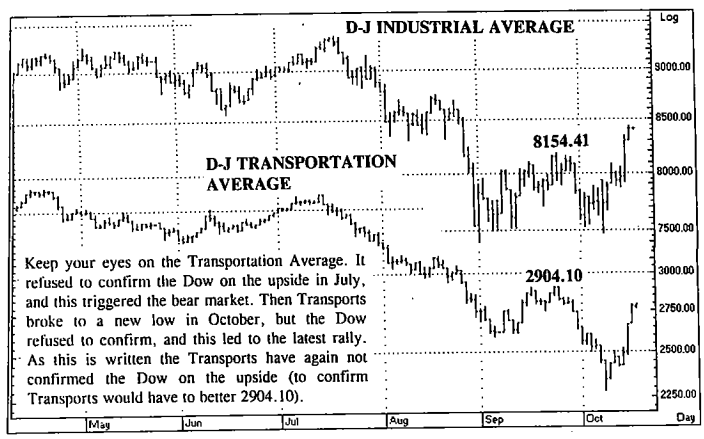
The Dow shot above its September 23 preceding peak of 8154.41, but as this is written the Transports have not confirmed; to confirm Transports would have to advance above their own (comparable) September 23 peak of 2904.10 (see chart). Remember, the Transports have been an excellent bellwether or leading indicator over the last seven months; for this reason, I would watch the Transports carefully, and I would not take the non-confirmation by the Transports lightly.

So far, this has been mainly a bear market for the great majority of stocks but much less so the big blue-chips. I've mentioned in almost every Letter that my Big Money Breadth Index (BBI) has not broken down (in fact it's held very well) -- the low for the BBI was struck back on June 3. So while thousands of stocks have been decimated, the big blues have been the barrier for the bear.

The two-tier market goes on with the A-D for the entire NYSE not far from its low and the BBI not too far from its July 17 high. How it will all work out only the bear knows, and right now he's not talking.

A good friend of mine (a very cynical fellow named Aaron Russo) phoned to tell me that "they" want to keep this market up until after the November election, and that, says Aaron, is why the Fed uncharacteristically rushed in to give the market a "zutz" (a zutz is defined as a shot of economic caffeine). Could cynical Aaron possibly be right? Nah, the Fed is non-political, we all know that. Seriously, however, I think the Fed sees the banks as risk-averse and afraid to lend, they see a global credit crunch, they see a possible recession starting in the first quarter, and they are now fighting the bear tooth and nail -- as I always said they would.

Note: The **bond market's reaction** to the Fed cuts was noticeably and surprisingly **weak.** For instance, the high for the Dec. Bond futures was hit on Oct. 5 at 135 8/32nds. On Friday, Oct. 16 (the day after the Fed cuts), the bonds drifted around the 129 level, a full six points under the high of a few weeks ago. What's happening? Those knowledgeable and very sophisticated bond traders are protecting themselves against what the Fed is creating -- **inflation.**


D-J INDUSTRIAL AVERAGE
Log
9000.00
8500.00
8154.41
8000.00
7500.00
D-J TRANSPORTATION AVERAGE
3000.00
2904.10
2750.00
2500.00
2250.00
Keep your eyes on the Transportation Average. It refused to confirm the Dow on the upside in July, and this triggered the bear market. Then Transports broke to a new low in October, but the Dow refused to confirm, and this led to the latest rally. As this is written the Transports have again not confirmed the Dow on the upside (to confirm Transports would have to better 2904.10).
May
Jun
Jul
Aug
Sep
Oct
Day

EVEN LATER THOUGHTS: Obviously I can't prove it, but I've had this scenario on my mind. I'm just afraid that this bear market is going to be a very long, drawn-out affair. The bear is intent on wearing us out. The reason I feel this way is because it's clear that the authorities won't allow the markets to express themselves, or I should say the authorities will do all they can to thwart the markets' expressing themselves. We saw this when Clinton came out with his "new world economy" speech. We saw this clearly when Greenspan changed his mind about how great things were -- then jumped in with a second cut in interest rates. Here's what I think -- the first chink in the authorities' efforts will come when a bail-out collapses. **The IMF or the US will not bail out an entity a second time.** Example, if Mexico collapses (and it could), I doubt seriously whether the US will bail it out again. Then what?

NEXT MAILING: Nov. 4, 1998